Directorate of
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International Economic & Energy Weekly

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15 April 1983

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Synopsis

Perspective—*OPEC: Crossing the First Hurdle* [redacted] 25X1

Buyer acceptance of British National Oil Company's recent minimal prices reduction and lack of retaliatory cuts by Nigeria and other OPEC members have firmed spot crude prices and renewed optimism that stability is returning to the oil market. Despite some signs that the decline in consumption has abated, however, it will take a sustained rebound in oil demand to underpin the present pricing structure and prevent some OPEC members from cheating. [redacted] 25X1

Nigeria: Further Economic Deterioration [redacted] 25X1

[redacted]

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Japan: Unusual Deficit Dilemmas [redacted] 25X1

Tokyo has had little trouble covering budget deficits so far, but problems could develop in the future because of refinancing needs. Prime Minister Nakasone has no clear plan to close the existing $58 billion financial gap, and large deficits are likely to persist through the end of the decade. [redacted] 25X1

Portugal: Coping with Financial Shortfalls [redacted] 25X1

Portugal's chronic international financial problems have become a major preoccupation of the country's policymakers. Whatever the makeup of the government formed after the partiamentary election on 25 April, the severity of the imbalance probably will force it to implement further austerity measures and to renew negotiations with the IMF for a standby loan. [redacted] 25X1

China: Economic Relations With the Third World [redacted] 25X1

China's increased public stress on its aligment with the Third World highlights the importance of Chinese economic as well as political ties to developing countries. Recent Chinese policy statements show that Beijing expects to increase its share of Third World markets, where China's favorable trade balance partially offsets the cost of Western imports. [redacted] 25X1

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15 April 1983

Perspective

OPEC: Crossing the First Hurdle [redacted] 25X1

Buyer acceptance of British National Oil Company's recent minimal price reduction and the lack of retaliatory cuts by Nigeria and other OPEC members have firmed spot crude prices and renewed optimism that stability is returning to the oil market. Despite some signs that the decline in consumption has abated, however, it will take a sustained rebound in oil demand to underpin the present pricing structure and prevent some OPEC members from cheating. [redacted] 25X1

Higher-than-anticipated oil sales in several major consuming countries have helped support the price structure and reverse market psychology. Oil sales in France and Italy rose by 5 and 3 percent, respectively, in February, and preliminary data indicate US consumption in March approximated year-earlier levels—in part reflecting increased gasoline sales prior to the 1 April tax increase. [redacted] 25X1

The apparent rebound in oil consumption may reflect an end to destocking at the secondary level. The mild winter and prospects of oil price declines probably caused consumers to run down stocks to minimum levels. Primary stocks were also being depleted rapidly. US commercial inventories reportedly fell by 2 million b/d in March—well above the normal rate—and stocks in Japan declined by 300,000 to 400,000 b/d during January and February. If companies believe that prices have stabilized and revert to a normal pattern of inventory accumulation, oil demand could rebound by about 2-4 million b/d in the coming months. [redacted] 25X1

Willingness by OPEC members to abide by the March agreement despite production levels that are in some cases below allowable ceilings has helped reverse market psychology. OPEC crude output in March averaged about 15.3 million b/d against the new quota of 17.5 million b/d:

- Iran has kept prices in line with the official benchmark, and reduced spot sales of oil; production has fallen to about 2.4 million b/d.
- Nigeria has decided to maintain its prices despite the United Kingdom's recent 50- to- 75-cent-per-barrel price drop; March production of about 900,000 b/d was 400,000 b/d below their ceiling.
- Saudi Arabia allowed production to fall to 3.3 million b/d in March, 400,000 b/d below February's level. Even output below the 3-million-b/d level in early March did not appear to shake Riyadh's resolve to support the new price structure.

[redacted] 25X1

OPEC has also benefited from non-OPEC producer pricing actions. The minimal drop in UK prices avoided a direct confrontation with OPEC, and most major British customers have at least temporarily accepted the new prices. Most other non-OPEC producers have made only minor price corrections and probably will not initiate cuts large enough to trigger a new round of lower prices. [redacted] 25X1

Despite current signs of stability in the oil market, the key to OPEC's ability to maintain prices will depend upon a sustained rebound in oil consumption. Should sharp declines in oil consumption return and continue well beyond midyear, the likelihood that some members will cheat on the agreement will increase:

- Nigeria continues to have critical revenue problems.

- Iran and Libya also have large foreign-currency requirements and neither were supportive of last year's OPEC agreement.

- Venezuela already appears to be setting the stage for producing above its quota. The American Embassy reports that Caracas will no longer be making its weekly crude oil production figures public and, according to a knowledgeable source, will probably continue to produce at about 2 million b/d—300,000 b/d above its assigned quota. [redacted] 25X1

[redacted] 25X1

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Briefs

Energy

Spot Oil Market Trends

Spot oil product prices increased sharply in late March and early April, raising the value of a barrel of crude oil to refiners by about $1.50. Spot product prices in the Rotterdam market now indicate a barrel of Arab Light is worth about $27.50 while Bonny Light is worth $28.90 per barrel. Most spot crude prices also firmed this week, with Arab Light prices now about equal to the official price of $29 per barrel. Although crude oil trading still remains relatively light, firming spot product and crude prices indicate that market psychology is reversing and surplus inventories are nearing depletion. If OPEC can maintain discipline on prices and production levels, spot crude prices could continue to firm in coming weeks. 25X1

Oil Prices in the Rotterdam Market *US $ per barrel*

	Arab Light			Bonny Light		
	Official	Spot	Yield	Official	Spot	Yield
February [a]	30.00	28.00	25.54	30.00	28.00	26.79
March [a]	29.00	28.00	26.00	30.00	28.25	27.32
April	29.00	29.00	27.53	30.00	29.00	28.87

[a] End of month.

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Iranian Oil Policy

Iran currently is abiding by its OPEC production quota of 2.4 million barrels per day, but sales may decline during the next few months unless Tehran offers discounts. Several of Iran's customers—such as Japan—are threatening to cut back on oil contracts being negotiated this month if Iran does not make additional price reductions. Tehran recently cut its official crude price to $28 per barrel for Iranian Light—only $1 below the Arab Light benchmark, in contrast to the $3 per barrel discount offered before the OPEC agreement. 25X1

At the new price and production level, Tehran's oil revenue will total $1.6 billion per month. Although this is about $500 million per month less than Iran was receiving before the agreement, it is still slightly more than needed to maintain current import levels. Iran is likely to abide by OPEC production guidelines during the next few months and maintain a tough line on prices. It probably will grant small discounts, however, to compensate for high freight and insurance rates in the war zone. The Iranians recognize the risks of a downward price spiral if members fail to adhere to the agreement. [redacted] 25X1

Canadian Gas Price Cut Threatens Mexican Earnings

Mexico's gas export revenues will fall sharply this year as its US customers cut purchases and Mexico lowers prices to meet Canadian gas price cuts. On Monday, Canada announced it would cut gas prices for US customers by 54 cents to $4.40 per thousand cubic feet (tcf). Earlier this month, US customers informed Pemex they would reduce purchases of Mexican gas from 300 to 180 million cubic feet per day, the minimum allowed under the current contract. Pemex officials have told US Embassy officers that they will probably match the Canadian price reduction as well as other discounts that Pemex believes Ottawa is likely to offer within the next month. Even with these price reductions, US buyers probably will not resume previous purchase levels of Canadian and Mexican gas in the short term. [redacted] 25X1
[redacted] the price would have to be about $3.50 per tcf to compete with US domestic gas and other alternative fuels in the current soft energy market. As a result, we expect Mexican gas export revenues to fall by at least $100 million from the $470 million earned last year. [redacted] 25X1 25X1

Rome Increases Petroleum Taxes

Rome has increased excise taxes on petroleum products to prevent oil price declines from being fully passed on to consumers. The government has totally offset price decreases on gasoline for private motor vehicles to encourage conservation. To boost sagging industrial production, Rome has only partially offset price declines for diesel oil used in commercial transportation, while heavy fuel oil price drops are being fully passed on. Officials expect $320 million in revenues this year from the tax increases and plan to use part of the proceeds to pay the difference between the "political price" agreed to for Algerian natural gas and the market price. Parliamentary approval of the natural gas price agreement has been stalled by debate on providing Italy's state energy agency, ENI, with an estimated $400 million in subsidies over the next three years. A parliamentary decision to use the fund's resources to subsidize ENI for the high-priced Algerian gas should pave the way for a final conclusion of the long-delayed Italian-Algerian gas accord. [redacted] 25X1

International Trade, Technology, and Finance

[redacted] 25X1

Developing Country Payments Arrears Up Sharply

Total arrearages on LDC external debts—both public and private—nearly tripled during 1982. [redacted] 34 IMF member countries accumulated payments arrearages of $18.7 billion in 1982; in 1981, 35 were in arrears by only a total of $7.1 billion. Africa dominated the group with 21 25X1 countries, followed by 10 Latin American LDCs. For the first time several larger and more developed countries emerged with sizable arrears in 1982, namely Mexico and Argentina with outstanding payments of $10.0 billion. Nigeria reportedly incurred large arrears as well. Jamaica, Senegal, Somalia, and Turkey eliminated their payments arrearages during 1982. 25X1

Developing Country External Payments Arrears

Year	Number of Countries	Billion US $
1975	15	1.0
1976	19	1.8
1977	22	4.1
1978	23	4.4
1979	25	5.0
1980	27	5.2
1981	35	7.1
1982	34	18.7

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External Payments Arrears *Million US $*

	1981		1982
Sudan	1,752	Mexico	8,278
Peru	1,142	Romania	2,341
Costa Rica	643	Sudan	2,283
Zambia	582	Argentina	1,758
Ghana	505	Costa Rica	1,224
Zaire	498	Zambia	910
Tanzania	342	Ghana	590
Turkey	320	Tanzania	415
Guinea	163	Sierra Leone	278
Sierra Leone	160	Togo	168
Other	993	Other	455

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Jamaica Fails IMF Targets

Jamaica failed to satisfy the IMF's March performance target and probably will either undertake substantial fiscal and exchange reforms to keep the three-year Extended Fund Facility (EFF) agreement on track or try to negotiate a new standby arrangement. Kingston fell at least $100 million short of the net international reserve target last month in addition to overshooting the ceilings on domestic credit and debt arrearages. IMF officials are pressing Kingston to further cut the budget, greatly expand the parallel exchange market, or both. Should Jamaica hesitate to take corrective measures, the 1981 agreement with the IMF could collapse altogether. The IMF already is considering a two-year standby arrangement that would carry less stringent performance criteria but would stretch the $165 million remaining under the EFF over a two-year period. 25X1

National Developments

Developed Countries

Israeli Government Assists Exporters

Under considerable pressure from exporters, the Israeli Government last week established a $140 million fund to promote exports and moved to reduce exporters' outlays by reducing national insurance payments and premiums for exchange rate insurance. The measures were enacted under emergency regulations and will be in effect for 90 days; a Finance Ministry official hinted to the press that legislation to extend the regulations will be presented to the Knesset after it reconvenes on 2 May. While helping exporters, Finance Minister Aridor demonstrated his determination to hold the line on the budget deficit by imposing a 1-percent levy on the purchase of foreign currency to generate revenue for the export-promotion fund. A Finance Ministry official told a US Embassy officer that the government is resisting calls to restrict imports because of its commitments to free trade and because of the fear of retaliation from Israel's trading partners. While these measures may provide some help to exporters, we do not expect any substantial gains in export earnings as long as Aridor continues his policy of slowing the depreciation rate of the shekel. 25X1

Successful West German Wage Negotiations

Modest settlements accepted last week by two major unions probably will set the pace for limited pay increases in West Germany and help stimulate sagging export industries. Despite labor support last month for a minimum pay increase of 4 percent, the large Metal Workers Union and Chemical Workers Union—which represent 25 percent of all West German workers under contract—have agreed to only a 3.2-percent wage increase. The current inflation rate is 3.5 percent. Most unions usually follow the precedent established by the powerful metal industry. A stagnant economy and record unemployment, which topped 2.5 million workers in February, have weakened

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the unions' bargaining position. Accepting the modest increase would mean that, for the third year in a row, West German workers will take a cut in real wages if price rises remain at the current level. The settlement should slow the increase in labor costs and help offset the upward pressure on the price of West German exports resulting from the revaluation of the mark in March. 25X1

Poor Economic Outlook for Australia

The economic summit this week of government, union, and business leaders was set against the most gloomy economic outlook in recent years. The new government last week predicted that inflation will climb to more than 12 percent in the fiscal year beginning this July and that the unemployment rate will remain above 10 percent through 1986. The pessimistic forecast may provide Prime Minister Hawke with justification for backing away from campaign promises to fund a jobs program and cut taxes. During the campaign, Hawke promised to bring business and labor together to reach a consensus on dealing with inflation and record unemployment. Hawke is increasingly concerned about the projected $8-9 billion budget deficit in 1984, however, and he is reluctant to implement a jobs program. At the same time, he is under pressure to increase trade protection. 25X1

Australian Government Rejects Foreign Investment Proposals

Citing a lack of sufficient economic benefits to Australia, the new Labor government has rejected the first two foreign investment proposals made since it assumed office on 11 March. A proposal by a US firm to acquire full ownership of a leading Australian distributor of industrial plastics was turned down as was a proposal by a Japanese firm to purchase land to build several hundred vacation homes. The decisions are consistent with the Labor Party's policy of eliminating exceptions to the requirement that Australians control at least 51 percent of any foreign investment venture. The former Fraser government had been lax in enforcing the domestic equity requirement, which became an issue during the recent election campaign. 25X1

Less Developed Countries

Mexico's New Private-Sector Debt Rescheduling Plan

Mexico announced last week a comprehensive program to help business reduce debt arrears by rescheduling private foreign debt. Under the program the government is pushing firms to reschedule their foreign debt over six to eight years with a minimum three-year grace period. After agreement is reached, the firms will have access to foreign exchange at subsidized rates for debt repayment. A new government trust fund, FICORCA, will administer the program, but the restructured loans—at IMF insistence—will not be guaranteed or become a liability of the public sector. 25X1

We believe many foreign creditors will agree to enter into debt rescheduling discussions rather than continue demanding repayments that many Mexican firms cannot meet. Even so, while complicated public-sector rescheduling exercises are under way, we expect the much smaller private-sector debt rescheduling efforts to take a back seat. As a result, we do not expect that the talks will be completed by the envisaged 25 October 1983 deadline. 25X1

Mexican Inflation and Labor Demands

Citing continuing high inflation and recent cuts in government subsidies, labor leader Fidel Velazquez last week called for an immediate hike in the minimum wage. During the January-March period, official statistics show inflation growing at an annualized rate of 140 percent. The government's move last week to lower subsidies for some fuels and milk are strengthening labor's case. The price of regular gasoline was hiked 20 percent, while the price of milk was raised 25 percent. In the hope that responding to labor's demands will ease political tensions, we believe that the government probably will move the promised 12.5-percent wage adjustment up a month or two from the July schedule. This action, however, would rekindle private-sector fears that President de la Madrid was slipping back to the anti-private-sector policies of his predecessor. 25X1

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Revenue Shortfalls in Bahrain and Qatar

Bahrain, expecting a 20-percent drop in oil revenues this year, is looking for ways to deal with a forecasted 1983 budget deficit of at least $250 million. So far, the government has decided both to reduce and stretch out capital expenditures; it has extended its four-year plan to six years. 25X1

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Bahrain could turn to its richer Gulf neighbors to cover a portion of the deficit. Since 1980, Bahrain has received a combined total of about $150 million per year from Saudi Arabia, the United Arab Emirates, and Kuwait. 25X1

At the same time, with oil revenues down by about one-third from last year, Amir Khalifa has announced that the Qatari Government will call for a 20-percent cut in expenditures in the fiscal 1983/84 budget, which begins in mid-April. [redacted] 25X1 25X1 The budget, while continuing to fund social welfare programs and industrial projects already in progress, probably will not provide for any major new projects. The development of Qatar's North Field gas reserves—a potential source of government revenue and a boost to Qatar's business community—faces further delays because of the depressed LNG market and the projected $6 billion price tag. [redacted] 25X1

[redacted] 25X1

Malaysia Signs Large Loan Agreement

Kuala Lumpur has completed negotiations with Western lenders for a $550 million, eight- to 10-year loan. The loan, to be used for financing general development, is Malaysia's first major borrowing this year. It carries a five-year grace period for repayments, with portions tied to the LIBOR and to the US prime rate. The interest rate spreads on the loan are slightly higher than those on Malaysia's record $1 billion syndication in 1982. [redacted] 25X1 Western banks were eager to participate in the syndication because of Malaysia's excellent international credit rating relative to other LDCs. [redacted] 25X1

Tanzania Tries To Slow Economic Slide

Tanzania has moved on several fronts to stem a severe economic decline caused primarily by a sharp drop in foreign exchange receipts from agricultural exports and international assistance. To stimulate farm output, President Nyerere has announced a National Agricultural Policy designed to open commercial farming to private individuals and companies. In addition, Tanzania last month reopened negotiations with the IMF for a one-year standby loan agreement. The regime also is waging a massive crackdown on black marketeering and government corruption in an attempt to restore trade—and resulting tax revenues. [redacted] 25X1

An early economic upturn, however, remains unlikely. The National Agricultural Policy and Finance Minister Msuya's more flexible posture toward the IMF are at odds with Nyerere's basic adherence to strict socialist economic policies. Implementation of such changes, therefore, may be slow and ineffective. Moreover, market inequities and commodity shortages will continue and probably will lead to renewed corruption and black marketeering once the crackdown passes. [redacted] 25X1

Trade Squabbles Weaken Caribbean Cooperation

Mounting trade disputes are undermining the fragile structure of the Caribbean Community (CARICOM):

- Barbados floated its currency against the Jamaican dollar in February in retaliation for Kingston's imposition of a two-tiered exchange rate that made imports costlier in the Jamaican market. Trade between the two countries has virtually halted since then.
- Trinidad and Tobago slapped a licensing requirement on all Jamaican imports in March.
- Barbados, the main lender to CARICOM's Multilateral Clearing Facility, abruptly pulled out of the facility two weeks ago. Members, who arranged credits and settled trade accounts in local currencies through the facility, now will have to use scarce foreign exchange instead.

Jamaica's manufacturers already are feeling the pinch—last year 80 percent of Jamaica's $82 million in CARICOM exports were to Barbados and to Trinidad and Tobago. The outlook for a quick resolution of the conflict is poor. According to US Embassy reports, Jamaica, struggling to meet IMF performance targets, is more likely to expand its new exchange system—or even devalue—than to retreat. [redacted] 25X1

[redacted] 25X1

[redacted]

25X1

Hungarian Joint Ventures

Budapest has recently liberalized rules governing joint ventures in an effort to gain greater access to Western technology and boost hard currency earnings. Although joint ventures have been permitted in Hungary for 10 years, high taxes, limited currency repatriation possibilities, and strict operating codes have discouraged potential Western partners and resulted in only 10 joint ventures, of which only four are still operating. Under the new legislation, joint ventures between Hungarian and Western firms will be considered foreign legal entities with offshore status. Among the new privileges to be granted such ventures are:

- Exemption from most regulations on profits, investments, and wages.
- Freedom to purchase production equipment and materials used in goods for reexport without paying import duties.
- The opportunity for Western partners to own the majority of shares in banking and service companies affiliated with the venture.
- Ability to raise credits from Hungarian or foreign sources and to dispose of hard currency assets. [redacted] 25X1

Although the new system still maintains some financial and currency controls, the combination of a more open business climate and the low wages and relatively high technical skills of the Hungarian labor force may attract some foreign capital. In a January deal between Zyma of Switzerland and the Hungarian Biogal Pharmaceutical Works, Hungary obtained access to $2 million worth of sophisticated equipment and a 50-percent share in profits by contributing plant space, 20 employees, and locally available equipment. [redacted] 25X1

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Nigeria: Further Economic Deterioration [redacted] 25X1

The weak market and Nigerian oil's lack of price competitiveness with similar North Sea and Libyan crudes caused oil production to plummet in the first two months of this year to the lowest levels since the end of the 1967-70 civil war. Output in this period averaged only about 70 percent of the 1 million b/d on which the budget is based and was less than half that produced in the same period in 1982. Production by mid-February had dropped to 430,000 b/d—one-fifth of capacity. Pressure on Lagos to lower the cost of its oil intensified following the decision by the British on 18 February to reduce prices by $4 per barrel. President Shagari responded two days later by cutting Nigeria's oil prices by $5.50 per barrel and raising profit margins for oil companies operating in Nigeria by 25 percent to $2 a barrel. The US Embassy in Lagos reports that these moves boosted output to just under 1 million b/d. An industry source has indicated that Nigerian production is falling once again, however, and will probably average 900,000 b/d for March. [redacted]

We believe that Nigeria's ability to raise its production to 1.3 million b/d specified in the latest OPEC agreement will depend on how flexible Lagos is with its pricing policies. The government has stated publicly that it will match price cuts implemented by the United Kingdom and Norway, producers of North Sea crude and Lagos's principal non-OPEC competitors. Nigeria is reassessing its oil sales policies as well. [redacted]

Adjusting to Reduced Revenues

[redacted] 25X1

Any additional decline in oil prices would make the adjustment process more painful. A fall to $20 per barrel, for example, would cost roughly an additional $3 billion in export revenues. To offset this loss, Lagos would have to decrease import growth by 50 percent. We believe that a reduction of this magnitude would have serious repercussions for the modern sector of the economy. Capital and intermediate goods constitute the bulk of Nigeria's imports—nearly 75 percent of the total, according to our estimates. [redacted] 25X1 25X1

Nigeria's foreign reserves are slightly more than $1 billion—roughly one month's worth of imports at the current rate—and only about $1.7 billion remains undisbursed on previously arranged credits.

Nigeria has been looking for bilateral assistance to help fill the gap. [redacted] Shagari may be forced to go to the IMF for help sooner than he would prefer or to implement even harsher austerity measures. [redacted]

[redacted] the government is trying to round up $2 billion in new bank loans, but with no success thus far. [redacted] The US Ambassador to Nigeria reports that Lagos wants to arrange as much financing as possible before resorting to IMF borrowing and its associated conditions. [redacted] Nigeria will have to agree to channel most new bank loans into paying off its $5-6 billion in commercial arrears. [redacted]

In the meantime, government austerity measures are having an increasingly severe impact on the economy. US Embassy reporting indicates that import restrictions are taking their toll on the availability of raw materials and manufactured goods. The automobile assembly industry is one of those hardest hit by the lack of spare parts. The Peugeot factory in Kaduna stopped production for two weeks because parts were unavailable and France will not extend additional credits until the $240 million owed for past deliveries is paid. The Volkswagen plant in Lagos periodically closes for several days at a time, and production now is only one-third of the normal rate. [redacted]

The economic slowdown has boosted unemployment sharply in the urban areas. [redacted] urban unemployment may be as high as 30 percent, double what it was a year ago. Various Nigerian labor and industrial organizations estimate that last year at least 45 firms closed or laid off employees, displacing between 50,000 and 150,000 workers. [redacted] the expulsion of illegal aliens from Nigeria earlier this year created 55,000 job vacancies at the ports and in construction, but in our judgment many of these positions have not been filled because of the downturn in economic activity, the accompanying slump in demand for services, and the reluctance of Nigerians to accept low-paying positions. [redacted]

Austerity has had an impact on essential consumer imports as well. In an effort to maintain imports of rice—an urban dietary staple—at normal monthly rates of 60,000 to 70,000 tons, Nigeria is switching from its traditional rice supplier, the United States, to lower quality, less expensive Thai rice. Bangkok also is offering favorable credit terms. [redacted] the US Embassy in Lagos reports that Thailand has captured nearly two-thirds of the Nigerian market. US sales of corn and wheat, which account for the bulk of Nigeria's imports of these commodities, also have fallen. According to US Embassy reporting, flour mills are operating at 50 to 70 percent of capacity, and new licensing regulations have cut down on the volume of corn imports. [redacted]

Tough Decisions Ahead

In our opinion, the Shagari government is increasingly concerned about preventing the deteriorating economy from becoming a major issue in this

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summer's elections, now scheduled to begin 6 August. According to recent Embassy reporting, prices of staple foodstuffs—particularly rice, yams, chickens, and palm oil—have risen by 65 percent since January. Although there has been little economically inspired unrest thus far, press reporting indicates work stoppages are spreading among such groups as employees of state governments and petroleum workers. Local distribution of petroleum products has already been disrupted in several cities. These developments come at a time when the election campaign is getting into full swing and could provide Shagari's opponents with ammunition. 25X1

In the absence of an unanticipated sharp increase in oil sales, we believe Shagari's economic options are limited.

- Additional austerity measures would probably spark labor and public unrest, particularly if they contained across-the-board salary cuts for civilian government workers. Reductions in the military payroll are unlikely because of the administration's hope to avoid antagonizing the Army during the sensitive election period. Further cuts in imports will only compound the problem of business closings and rising urban unemployment.

- Going to the IMF will require a devaluation and other structural adjustments in the economy. A devaluation, however, would further strain already scarce foreign exchange resources and boost inflation. Such a move—particularly if accompanied by debt rescheduling—would likely be cited by Shagari's opponents as the most graphic sign yet that the government has squandered the country's oil wealth. 25X1

It is our judgment that the economy will be one of Shagari's most worrisome problems between now and the elections. An increasing preoccupation with winning the election probably means that he will be less interested in keeping close tabs on financial developments. As a result, we anticipate that the government will do what it can to maintain imports of essential consumer goods and make timely payments on medium- and long-term debt, especially interest. Lagos also will continue to seek new credits on international financial markets or, if not successful, add to its already sizable volume of commercial arrears. We believe that the Nigerians will avoid a public appeal for IMF assistance, although we cannot rule out the possibility that they will sound out the Fund privately as to what conditions would be required. 25X1

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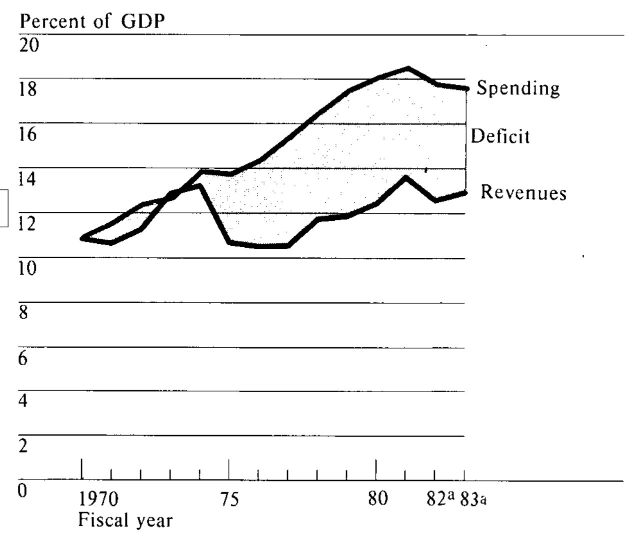
Japan: Unusual Deficit Dilemmas 25X1

Japanese officials are deeply concerned over the size of the government deficit. Tokyo has had little trouble covering budget deficits so far, but problems could develop in the future because of refinancing needs. Prime Minister Nakasone has no clear plan to close the existing $58 billion financial gap, and large deficits probably will persist through the end of the decade. We believe Tokyo will be forced to offer more attractive terms on government issues in order to continue financing its deficits through domestic capital markets. 25X1

Small Government but Big Deficits

As a share of GDP, Japan has the smallest government among major industrialized countries. This statistic, however, masks a fivefold rise in government outlays since 1970, generated by Tokyo's use of fiscal stimulus to pull the economy out of a series of recessions. General account spending now is equal to about 18 percent of GDP compared to 11 percent in 1970. 25X1

Japan: General Account Revenues, Expenditures, and Balances



a Estimated.

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To help fund the government's increased spending, Tokyo has let the tax burden edge upward. The tradition of annual tax cuts ended in FY 1977, and, with a highly progressive income tax system, individuals quickly felt the pinch of inflation-induced bracket creep. Corporate tax burdens also increased as the government began dismantling an extensive system of special tax incentives, established in the early 1950s to encourage investment. Even so, revenue has not kept pace with expenditures as slumping profits in the past few years have limited the corporate income tax take.

Tokyo also abandoned a balanced-budget rule dating from the US occupation. In 1965 Tokyo started floating "construction bonds" for specific public works projects totaling about 1 percent of GDP.

The surge in government borrowing, however, began in 1975 when the government issued "deficit-financing" bonds to cover current—as opposed to capital—spending needs. The deficit immediately widened to 3 percent of GDP and climbed to nearly 6 percent in 1979. Conservative fiscal policies during the Suzuki and Nakasone administrations reversed this upward spiral. Nonetheless, the FY 1983 budget, which took effect on 1 April, authorizes roughly $58 billion in bonds, equal to about 4.5 percent of projected GDP. 25X1

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Japan: Government Financial Indicators *Trillion yen*

Government Bond Issues		Government Debt Expenses		Maturing Government Debt [a]	
Fiscal Year	Amount	Fiscal Year	Amount	Fiscal Year	Amount
1975	5.28	1975	1.10	1982	3.86
1976	7.20	1976	1.84	1983	5.26
1977	9.56	1977	2.31	1984	9.67
1978	10.67	1978	3.23	1985	11.51
1979	13.47	1979	4.37	1986	14.89
1980	14.17	1980	5.49	1987	14.43
1981	12.90	1981 [b]	6.65	1988	16.30
1982 [b]	14.34	1982 [b]	6.60	1989	17.29
1983 [b]	13.34	1983 [b]	8.10	1990	18.53

[a] Ministry of Finance estimates made in late 1982.
[b] Estimates [redacted] 25X1

[redacted] 25X1

Current Impact and Future Worries

Despite the persistence of massive budget deficits, the government has had little trouble financing its needs and has not crowded out the private sector. In the wake of the 1973 oil crisis, private-sector savings shot up to 20 percent of GDP. While uncertainty stemming from the oil shock boosted savings, it also reduced corporate investment. As a share of GDP, investment fell from 25 percent in the early 1970s to 15 percent in the later years of the decade. The government deficit, moreover, frequently failed to absorb fully the pool of excess private savings, and Japan switched from a net borrower on international capital markets in the years prior to 1973 to a net lender since 1975. [redacted]

Japanese officials, however, remain worried about funding future deficits. Japan's Economic Planning Agency projects a slight decline in savings during the 1980s. They believe that as the population ages, the savings rate will trend downward. A more immediate concern is the ability of the domestic capital market simultaneously to fill heavy new government debt requirements and refinance old issues. Tokyo's heavy reliance on five- and 10-year bonds has led to a bunching up of maturing issues. Annual redemption requirements averaged $4 billion through FY 1980 but rose to nearly $16 billion last year. [redacted] 25X1

Splits Over Solution

While agreeing on the desirability of eliminating deficit-financing bonds, government and private-sector leaders are split over the best way to reach this goal. In general, Japanese bureaucrats want to close the financial gap by boosting government revenues [redacted] 25X1

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In line with their concern about "bracket creep," private-sector groups want spending cuts instead of tax hikes. As examples of areas where cuts could be made, the Keidanren—Japan's leading business association—cites generous subsidies for rice farmers and overstaffing at the Japan National Railways. The Administrative Reform Committee, appointed by the government in 1981 to suggest ways to eliminate government waste, initially recommended that Tokyo cut subsidies 10 percent across the board and revamp government agencies. These suggestions, however, were watered down in the final report in March, probably reflecting the political clout of vested interest groups [redacted]

Nakasone's Program

Without a consensus on how to eliminate deficits, Prime Minister Nakasone is confronted with painful policy decisions. Because of the current deficit, influential bureaucrats in the Finance Ministry oppose major fiscal stimulus as a way to spur government revenue. With elections scheduled for this summer, the Prime Minister is unwilling to antagonize voters by proposing tax increases. Nakasone lacks the political clout to get the Diet to approve cuts in sacred-cow programs such as rice subsidies and tax-free savings accounts. [redacted]

Nakasone has managed a difficult balancing act in the FY 1983 budget. On the surface, the budget is austere—allowing only a 1.4-percent increase in spending over last year's initial level. One Japanese newspaper termed it a "window dressing budget," however, because transfers to local governments were slashed 20 percent while spending in other categories was allowed to rise. Some of these transfers could be reinstated later in the year, when Tokyo traditionally adopts a supplemental budget. [redacted]

The economic stimulus package approved by the Cabinet on 6 April fails to give any better indication of which way Nakasone wants fiscal policy to move. [redacted]

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[redacted]

Rather than trying to spur domestic economic activity by loosening fiscal policy, the package recommends that favorable international economic developments—such as falling oil prices and declining interest rates—be exploited. The US Embassy in Tokyo believes the program will have limited macroeconomic impact. Using our version of the Economic Planning Agency econometric model, we reached the same conclusion. [redacted]

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With the FY 1983 budget approved by the Diet and the economic stimulus package announced, Nakasone will not have to deal with the deficit issue again until summer when the Diet is scheduled to debate a tax cut. Unions and other private-sector groups want an income tax cut of roughly $4 billion. Finance Ministry officials will probably continue to press for an $8-12 billion hike in indirect taxes. At this point, we believe Nakasone will opt for a neutral policy, where any indirect tax increase merely offsets any cut in direct taxes. [redacted]

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Bond Market Liberalization Imperative

Few Japanese foresee an imminent end to the issuance of deficit-financing bonds. The Ministry of Finance talks of eliminating them between FY 1987 and FY 1991. Dai-Ichi Kangyo Bank is even more pessimistic. Without a large tax increase, the bank estimates it will take 19 years to phase out deficit-financing bonds; with a tax increase, 12 years. [redacted]

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As a result, we believe that Tokyo will have to liberalize capital markets more rapidly than they would prefer to meet deficit funding requirements. Some Japanese blame recent moves in this direction, including private placements of yen-denominated government bonds overseas, for the volatility of the yen in 1982 and claim that Japan's ability to

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Government Bond Market in Japan

Unlike the United States, Japan does not auction off all government bonds. Most new issues consist of five- and 10-year bonds, which are underwritten by a syndicate of domestic banks, security houses, and insurance companies. After the syndicate and the Ministry of Finance agree on interest rates for the monthly issues, syndicate members absorb the bonds into their portfolios. While the security houses are free to resell immediately the bonds to the public, the city banks—which take about 30 percent of the new issues—must wait at least 100 days before they can do likewise. After one year the city banks can sell government bonds to the Bank of Japan, but the central bank's offered price has traditionally been unattractive. The Bank is prohibited from directly underwriting new issues. [redacted]

To improve flexibility, Tokyo has made several innovations in the system in recent years:

- *1978—Two- and three-year bonds were introduced. Investors can purchase these bonds through a tender system at market rates.*
- *1980—Tokyo authorized private placements of government bonds with the Saudi Arabians.*

[redacted] 25X1

- *February 1983—Ministry of Finance made first private placement of 15-year bonds with Japanese trust company syndicate. Yields are to be adjusted annually, but resales are prohibited.*
- *April 1983—Japanese banks were given permission to sell 10-year government bonds over the counter.* [redacted] 25X1

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pursue an independent monetary policy has been restricted. They fear that further liberalization will threaten the country's low interest rate structure. [redacted]

Despite these qualms, Tokyo has little choice but to let the government bond system become more market oriented. The banks in the underwriting syndicate have begun to balk over accepting large volumes of low-interest government paper. In February long-term government bonds were not issued because the banks found the Ministry of Finance's terms unacceptable. In March, the Ministry had to edge up the yield to induce the syndicate to resume purchases. Repeated episodes of this sort are likely unless Tokyo changes its financing system, perhaps by offering a wider range of maturities, market-determined yields, and expanded access by other financial institutions. [redacted] 25X1

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[redacted] 25X1

Portugal: Coping With Financial Shortfalls

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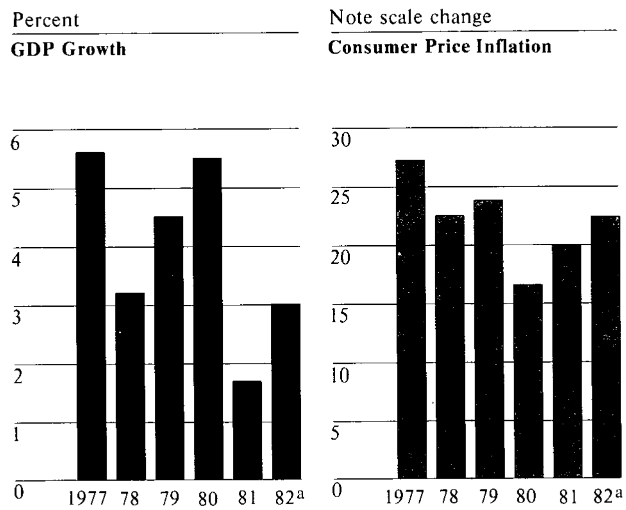
Portugal's chronic international financial problems have become a major preoccupation of the country's policymakers. Whatever the makeup of the government formed after the parliamentary election on 25 April, the severity of the imbalance probably will force it to implement further austerity measures and to renew negotiations with the IMF for a standby loan. 25X1

Portugal: Economic Indicators



a Estimated.

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Origins of the Deficit

Portugal has struggled with international financial problems since 1977, when a current account deficit of $1.5 billion compelled the Socialists to obtain a $70 million standby loan from the IMF and a $750 million credit from a consortium of 14 governments. The adoption of an IMF-mandated stabilization program and a 0.75-percent monthly rate of depreciation for the escudo stimulated exports and invisibles and swung the current account close to balance by 1979. However, the turnaround in Portugal's external position was short lived. Lisbon loosened its monetary policy in 1980; this had the desired effect of promoting investment and employment, but the added stimulus put pressure on prices. 25X1

Lisbon responded by imposing price controls and in an unconventional effort to minimize the effects of such controls on an import-dependent economy, it revalued the escudo by 6 percent. At the same time, the monthly exchange rate adjustment depreciation was resumed at a slower rate of 0.5 percent. The reduced pace of depreciation was not enough to offset Portugal's inflation rate. The resulting loss of competitiveness, combined with the worldwide downturn in trade, slowed export volume growth to 8 percent in 1980—down from 29 percent a year earlier. At the same time, the exchange rate adjustment prompted a 12-percent increase in the volume of imports, and the trade deficit shot up to $4.2 billion. The invisibles balance was also affected; tourism and worker remittances in 1980 grew at about half the rates recorded in the two preceding years. The current account deficit climbed to $1.3 billion, leading Portuguese officials to approach the IMF for a $1.5 billion medium-term Extended Fund Facility—a request subsequently tabled when Lisbon found the IMF's terms too stringent. 25X1

Despite the growing current account deficit, Lisbon pursued a relatively easy monetary policy during

Portugal: Balance of Payments

Million US $

	1977	1978	1979	1980	1981	1982 [a]
Trade balance	−2,532	−2,408	−2,632	−4,206	−5,162	−4,930
Exports, f.o.b.	2,001	2,379	3,550	4,575	4,089	3,997
Imports, f.o.b.	4,533	4,787	6,182	8,781	9,251	8,927
Invisibles balance	1,037	1,582	2,580	2,948	2,452	1,615
Of which:						
Net tourism	268	431	695	859	778	634
Worker remittances	1,174	1,671	2,455	2,928	2,839	2,581
Interest payments	142	387	536	733	1,099	1,319
Current account balance	**−1,495**	**−826**	**−52**	**−1,258**	**−2,710**	**−3,315**
Change in reserves	−359	103	68	−120	−190	−200

[a] Estimated.

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first-half 1981. Coupled with general economic stagnation in Western Europe, this approach exacerbated Portugal's economic problems. Consumer price inflation jumped from 16.6 percent in 1980 to 20 percent in 1981, widening the differential between the Portuguese inflation rate and the average OECD rate to over 9 percentage points. Nevertheless, the Bank of Portugal failed to accelerate the rate of depreciation, which contributed to a 3-percent fall in export volume. At the same time, imports grew by 3.5 percent, creating a $5.2 billion trade deficit. Other current account items once again failed to offset the trade deterioration. Worker remittances declined for the first time by 3 percent, reflecting an awareness of Portugal's negative real interest rates, while high interest rates on the Eurodollar market and the rapid expansion of foreign borrowing raised interest payments by 50 percent.

Lisbon's current account woes continued last year despite some improvement in the trade account. Tighter monetary policy, together with import restrictions, helped to reduce imports by $300 million. The return to a 0.75-percent monthly depreciation rate in December 1981 and a 9-percent devaluation of the escudo in June 1982 helped to restore export competitiveness and to boost real exports by 4 to 5 percent. Although the dollar value of exports fell slightly last year, in terms of escudos exports rose 26 percent, and the trade deficit narrowed by approximately $200 million, according to preliminary estimates. However, sharp drops in worker remittances and tourism—which were adversely affected by the recession in Western Europe—coupled with rising debt service payments reduced the invisibles surplus to only about $1.6 billion. The current account deficit thus widened to approximately $3.3 billion. 25X1

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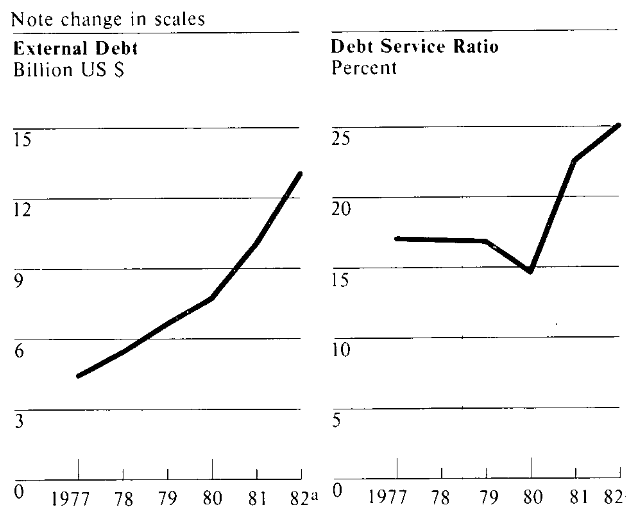
While Portugal's recurrent balance-of-payments deficits since the 1978 stabilization program are attributable in large part either to mistaken government policies or to worldwide conditions beyond the government's control, a variety of structural deficiencies have also come into play. Given its low agricultural productivity and lack of natural resources, Portugal must import 60 percent of its food and 80 percent of its fuel. Since these items—together with intermediate products for industry—

comprise 80 percent of Lisbon's foreign purchases, it has been difficult to curtail imports. Export growth has been dampened because of Portugal's concentration on low-technology goods, which have encountered growing protectionist sentiment in Western markets and stiffer competition from newly industrialized countries. Moreover, foreign exchange earnings from tourism declined steadily between 1980 and 1982, partly because of falling investment in the tourist industry and comparatively high hotel rates. In addition, the nationalizations carried out during 1975 and 1976 have created an overgrown and inefficient network of publicly owned corporations with financing requirements that have enlarged both the budget deficit and the external debt.

Portugal: External Indebtedness



[a] Estimated.

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External Borrowing

A significant portion of Portugal's current account deficits over the last three years has been financed by foreign borrowing. From 1979 to 1982, Portugal's external debt nearly doubled to approximately $13 billion—over half the country's GDP. Meanwhile, with interest rates and debt mounting, interest payments more than doubled, reaching approximately $1.3 billion in 1982. As a share of foreign exchange earnings, debt service payments, excluding the amortization of short-term debt, increased from 16.8 percent in 1979 to about 25 percent last year. Short-term debt more than doubled in just two years, reaching $3.2 billion in 1981; of this amount, publicly owned firms owed 85 percent. Last year, however, the growth of short-term debt slowed considerably because of government constraints on borrowing. Medium- and long-term borrowing, which presently accounts for about 70 percent of total debt, grew more slowly than short-term debt, rising from $5.3 billion in 1979 to nearly $9 billion in 1982.

Efforts To Reduce the Payments Deficit

The strategy currently in place for remedying the current account deficit is that of caretaker Prime Minister Balsemao. In short, the government is trying to raise import prices and reduce real personal income. The provisional 1983 budget raises the import surcharge from 10 to 30 percent. In addition, it provides for stiff tax increases and price hikes ranging from 15 to 30 percent for fuel, electricity, and transportation. The Balsemao government has also issued wage guidelines that require firms and workers either to pay 60 percent of any wage increase over 17 percent into the Social Security fund or to purchase government bonds. Lisbon expects these measures to cut real private consumption by 1 percent this year.

Despite earlier proposals to reduce real public expenditures in the 1983 budget, Parliament approved a 21-percent nominal increase. This implies that real spending will remain constant. Although the government failed to constrain expenditures, the increase in revenues held the budget deficit to $1.6 billion, the same as in 1982. [redacted]

In recent weeks, Lisbon has adjusted foreign exchange and monetary policies in response to recommendations from the IMF. The central bank has devalued the escudo by 2 percent against a basket of 18 currencies and raised the crawling rate of monthly depreciation from 0.75 to 1 percent. The revised rate more closely approximates the inflation differential between Portugal and its major trading partners and should help to maintain export competitiveness. The Bank of Portugal simultaneously increased interest rates by 4 to 5 percentage points. Interest rates are now well above the inflation rate for the first time in over a decade, which in addition to slowing inflation may encourage workers abroad to repatriate more of their earnings. In addition, the central bank imposed monthly external credit ceilings in an effort to slow the growth of foreign debt. Excepting the size of the devaluation, the measures are virtually identical to the IMF's recommendations. [redacted]

Outlook

Enter the New Government. The direction of economic policy probably will not change much even if—as we expect—the Socialists win a plurality of seats in Parliament in the 25 April election. In fact, Mario Soares, who would become Prime Minister, has proposed further austerity measures, such as increasing the prices of subsidized goods. Soares also has suggested a social pact among government, business, and labor aimed at resolving Portugal's economic difficulties. The implementation of an austerity program of the sort Soares envisions would require a reduction in real wages, a proposition that has already sparked labor unrest. Railroad and transport workers, for example, have struck for one or two days each week for over a month, demanding wage increases of 25 to 28 percent, far above the Balsemao government's offer of 14 to 16 percent. For its part, the powerful Communist-led General Confederation of Portuguese Workers–Intersyndical has vowed to increase strike activity if the new administration does not meet its terms. [redacted]

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A Smaller Deficit Likely Next Year

Even without the enactment of additional measures, the combined effect of reduced real purchasing power and declining oil prices could cut imports as much as $500 million, according to Embassy estimates. Invisibles earnings, however, probably will remain weak; low economic growth in Western Europe and restrictions on the amount of money French travelers can spend abroad make a rebound in worker remittances and tourism unlikely. Moreover, the expansion of Portugal's external debt will raise interest payments, even if interest rates fall. Consequently, we expect the 1983 current account deficit to approach $2.5 billion. [redacted]

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A sharper reduction of the current account deficit would require more fiscal restraint than has been evident in the past. The government overshot its budget deficit target by at least $400 million in 1982, primarily because of rising interest payments, failure to control spending, and expenditures on housing projects. Continued pressure in these areas is likely to lead to a budget deficit of at least $2.3 billion this year. Since the deficit is financed mainly through money creation and external borrowing, the government is likely to turn to the international market this year for close to $1 billion, instead of the $650 million it projected in its budget. [redacted]

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Prospects for Financing. Lisbon has encountered resistance from bankers recently but should be able to meet its foreign borrowing requirement. The representatives of US banks involved in Portugal have expressed concern about the country's long-term prospects, but they are still willing to extend credits, albeit at somewhat harsher terms. In view of Portugal's uncertain political and economic outlook, bankers want Lisbon to pay a higher spread over LIBOR than in the past. Official reluctance to pay a wider margin caused the state-owned savings bank to withdraw a $150 million syndication in February. A similar loan sought by the public utility company initially generated a weak response from the international financial community; however, it was successfully syndicated at steeper terms. Lisbon recently agreed to pay 0.75 percentage point over LIBOR for one tranche and 0.35 to 0.40 percentage point over the US prime rate for the other in order to market a $300 million Eurodollar credit. Bankers are also insisting that the Portuguese pay a slightly higher rate to roll over short-term loans. [redacted]

[redacted] in addition to requesting new credits, the government may ask that a portion of its short-term debt be converted into long-term loans by the end of this year. The Portuguese are postponing presentation of a formal request, probably in the hope of extracting more favorable terms once the successor government announces a stabilization program. [redacted] 25X1

In the meantime, Portugal has adequate reserves to avert a near-term crisis. Total reserves of nearly $9 billion are sufficient to meet the amortization payments on medium- and long-term debt estimated at $1 billion and total interest payments of at least $1.3 billion this year. However, the reserves consist almost entirely of gold; foreign exchange reserves cover only about two weeks of imports. Lisbon has tried to avoid selling gold because of the impression this would create abroad and probably because it plans to pledge gold against loans. The shortage of hard currency may be responsible for the drawdown of demand deposits held with foreign banks and the increased use of interbank credit lines. [redacted] 25X1

IMF assistance should be forthcoming after the elections. Lisbon is working to arrange a $140 million compensatory financing facility to make up for the shortfall in exports experienced in 1981. Negotiations for a $1.5 billion standby loan have not started because the caretaker government lacks the authority to sign an agreement. However, the Socialists have expressed their determination to approach the IMF if elected, despite the possibility that the degree of austerity this implies could ultimately cut into their popularity. [redacted] 25X1

[redacted] 25X1

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25X1

China: Economic Relations With the Third World [redacted] 25X1

China's increased public stress on its alignment with the Third World highlights the importance of Chinese economic as well as political ties to developing countries. Recent Chinese policy statements show that Beijing expects to increase its share of Third World markets, where China's favorable trade balance partially offsets the cost of Western imports. The Chinese portray their policies as enhancing economic cooperation among developing countries—a description that seeks in part to compensate for cuts in China's foreign aid programs and to blunt criticism from developing countries over China's increased competition for international assistance and markets. [redacted]

Economic Ties to the Third World

At the 12th Party Congress in September, China's leaders emphasized that Beijing expects trade to play an essential role in China's economic development. Although the United States and other industrial countries continue to occupy the key positions in Chinese trade planning, future plans did not overlook the Third World. China's $6.0 billion in exports to LDCs in 1981 constituted about 35 percent of all exports—and significantly, the Chinese enjoyed a surplus of $4 billion that offset their deficit with the developed countries.[1] On the military side, in 1981 the Chinese signed contracts for some $2.9 billion in arms exports to Third World customers [redacted]

China's Third World trade concentrates primarily on the OPEC states and the newly industrializing countries (NICs)—excluding Taiwan and South Korea. The Chinese also consistently run small bilateral surpluses that are significant in the aggregate with the poorer developing countries. [redacted] 25X1

The oil producers are key targets for China:

- Since 1979 China's exports to the Middle East and North Africa have risen more than 60 percent to $1.5 billion in 1981; a decline of imports in 1981 from the region gave Beijing a $1.2 billion trade surplus.
- Most of China's 30,000 overseas workers are in this area; the government's principal labor contracting arm—the China Construction Engineering Corporation—maintains offices in Iraq, Kuwait, and North Yemen and plans another in Dubai this year. 25X1
- The Chinese are targeting countries led by radical and conservative regimes alike as new markets; a new agreement with Libya will expand investment and trade [redacted] 25X1
- Finally, burgeoning Chinese arms sales are concentrated in the Middle East [redacted] 25X1

Chinese trade officials see good potential for increasing trade with the NICs as well. Recent developments support this conclusion: 25X1

- In 1981 Hong Kong reexported about $1 billion in Chinese goods to other LDCs, mostly to the NICs in East Asia, including Taiwan and South Korea. 25X1

[1] In 1981 Chinese exports to Hong Kong were worth about $5.3 billion and Beijing had a $3.3 billion surplus. These figures are not included in those above except for approximately $1 billion worth of goods reexported to other LDCs. [redacted]

- Beijing has almost doubled its total exports to Singapore since 1979. In 1981 China exported $735 million worth of goods while reducing imports, leaving Beijing a surplus of more than $550 million.

- Exports to Brazil reached $360 million in 1981 and accounted for nearly 60 percent of China's exports to Latin America. [redacted] 25X1

In the poorer developing countries, Beijing is also searching for markets:

- Beijing has an economic umbrella agreement with each of the 45 African states with which it has diplomatic relations. Total trade with Africa was about $1.2 billion in 1982, probably lifting China's trade surplus above the 1981 level of $440 million.

- Two-way trade with Latin America hit $1.2 billion in 1981. China has reduced its imports from Latin America, but continues to seek new outlets for its products. In early November, for example, Chile approved a new Chinese trade center that will serve a number of other South American countries. [redacted] 25X1

Marketing Strategy

Chinese officials usually cite China's ability to export low-cost intermediate-technology goods as the key to China's penetration of Third World markets. The Third World is a convenient marketplace for China's surplus industrial products, such as electrical appliances and machine tools, that have limited prospects in developed countries because of their low quality. The arms trade also takes up excess productive capacity while helping the Chinese to modernize their own military. [redacted] 25X1

Beijing is clearly looking for rapid growth in its trade with the LDCs. In public as well as unofficial commentary, Chinese officials suggest that closer ties with countries in Asia, Africa, and Latin America could open a vast market for China's goods. Moreover, the Chinese see a huge market for projects involving the export of Chinese labor.

[redacted] 25X1

Beijing is looking closer at more direct involvement in joint economic projects overseas. In September, trade officials announced that while joint projects with foreign investors are becoming more numerous in China, the Chinese are now playing an investor's role in the Third World, where they claim China can offer an attractive partnership with its own technical and managerial skills. [redacted] 25X1

Foreign Policy and Economic Relations

We believe that China is trying to create a more coherent political and economic policy that can serve Chinese goals in the Third World over the longer run. On the one hand, Beijing is singling out the political value of new economic initiatives in the Third World. China appears to be using economic diplomacy in an attempt to woo the more radical Arabs, such as South Yemen and Libya, away from the Soviets. As for the moderate Arab countries, the Chinese appear to regard stepped-up economic relations with Saudi Arabia and Kuwait as the first move toward diplomatic relations. Beijing also hopes that its offers of increased trade will encourage Latin America holdouts to drop diplomatic relations with Taiwan. [redacted] 25X1

At the same time, Beijing is publicly burnishing its identity as a leader in Third World affairs, building on existing good will. The Chinese are highlighting such areas as the exchange of technology and joint economic projects, in part, to suggest that such cooperation supplants the cuts in China's foreign aid programs over the past few years. The Chinese are also more actively counseling Third World representatives to cooperate in international negotiations and seeking to use a unified Third World stand in international forums to their benefit.

Beijing is stepping up its charges that the West is paying less for commodities, charging exorbitant interest rates, and erecting trade barriers to shift the impact of the global recession to the Third World. At the IMF meetings in Toronto last fall, the Chinese backed a doubling of IMF quotas and an increase in contributions to the International Development Association for low interest development loans. The proposal for lower tariffs among Third World countries and the establishment of a unified tariff structure for nonmembers also received Chinese support at the "Group of 77" meeting in New Delhi last February. At a meeting of South–South Cooperation in Beijing this month the Chinese reiterated support for these positions and introduced other proposals for further cooperation. [redacted]

Competition With the Third World

China's competition with other Third World countries for Western markets complicates Beijing's political relations with the developing nations. China's efforts to increase exports while holding down Third World imports have also produced intermittent frictions. The Algerians complained about the policy to Zhao Ziyang on his African tour last month. Indian concerns that China's low per capita income could give it some priority for the World Bank's development funds and other soft loan programs are also shared by many other Third World countries. [redacted] 25X1

China's response to these Third World concerns so far has been relatively weak. We believe the Chinese at this point may not judge the problem sufficiently important to warrant greater attention. Until now, Chinese trade competition has had the greatest effect on the NICs in East Asia—South Korea, Taiwan, Hong Kong, and Singapore. Beijing hopes to replace these NICs as producers of intermediate technology and labor-intensive goods as they move into high-technology industries. As far as these countries are concerned, the political fallout from direct economic competition is not a major Chinese worry. At the same time, China appears to believe that it can publicly place the onus for shortages in development funds available to the Third World on Western reluctance to increase contributions to the international financial institutions rather than on Chinese claims on such funds. In any event, by identifying themselves as a member of the Third World, the Chinese are sending the message that they intend to claim their share of international markets and development funds. In our view, this leaves little room for Beijing to soften the effects of its trade or other competition beyond the political palliatives and limited economic initiatives that have already been taken. [redacted] 25X1 25X1

[redacted] 25X1

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